

J. Unjustified Subsidization of Non-Utility Activities

Staff argues (Br., p. 28) that the Company "allocated too much of the project price to IAWC" and, therefore, seeks Illinois ratepayer subsidization of non-utility operations. Staff (Br., p. 28) further asserts that the use of gross property, plant and equipment ("gross PP&E") as the basis to allocate the purchase price is problematic. As Mr. Hartnett explained, however, in October, 1999, when AWW made its offer to CUC, AWW had sufficient information to prepare a combined DCF for all of Citizens' water operations to determine an offer price, but had to allocate the price to each state on the fairest basis possible. Given the nature of an asset purchase transaction, the original cost of the assets (gross PP&E) was the most logical basis upon which to allocate fair market value. [IAWC Ex. 4.0R, p. 3.] Moreover, had AWW utilized the net PPE factor to allocate purchase price, as suggested by Ms. Langfeldt, the amount of the purchase price allocated to Utility Assets in Illinois would have increased. [Tr. 458-59.] For these reasons, use of the purchase price in calculating the amount of the Acquisition Premium does not (as Ms. Langfeldt suggests) cause a violation of Section 7-204(b)(2) of the Illinois Public Utilities Act. [IAWC Ex. 4.0R, p. 3.]

As discussed in the Company's Initial Brief (pp. 72-73), the allocated purchase price is fully supported by an Illinois-specific DCF analysis. As Mr. Hartnett explained, DCF is a reliable valuation technique which assumes that the value of the Utility Assets is equivalent to the value of projected future cash flows, including cash flows from Acquisition Savings. [IAWC Ex. 4.0R, p. 8.] The Illinois DCF analysis clearly indicates that Illinois cash flows (\$221 million) support the purchase price for the Utility Assets (\$219 million). [*Id.*]

Staff (Br., p. 29) maintains that the Illinois DCF analysis has several problems which make it an unreliable assessment of the Utility Assets' value. Specifically, Staff (Br., p. 29)

refers to Ms. Langfeldt's testimony that the Illinois DCF analysis improperly failed to reflect tax benefits related to the transaction and that the analysis did not reflect the same level of Savings as is shown in IAWC Exhibit 3.1R [Staff Ex. 9.00, p. 13.] As Mr. Hartnett explained, however, Ms. Langfeldt is wrong in saying the tax benefits are not included in the DCF analysis. As was explained in Mr. Hartnett's testimony and in the response to Data Request RL 8.02, the DCF analysis was updated to reflect the tax benefits during the negotiations with Citizens. [IAWC Ex. 4.0SR, p. 4.] Furthermore, the fact that the level of savings shown on IAWC Exhibit 3.1R differs from that used in the DCF analysis was clearly explained in the response to Data Request RL 8.04. [*Id.*, p. 4.] The Savings used for the DCF analysis were the preliminary synergies identified during pre-offer due diligence. Additional data was made available after the offer and such additional data was reflected in Exhibit 3.1R. [*Id.*] The Savings used for the DCF analysis are the same Savings as are included in Attachment 4(c)-12 to Staff Data Request 1.02. [*Id.*] Staff's criticism of the Illinois DCF analysis is, therefore, baseless.

Staff asserts (p. 30) that, to properly allocate the purchase price of the Utility Assets, it would be necessary to calculate the ratio of the Project's purchase price to its post-acquisition market value. As Mr. Hartnett indicated, however, this is a mathematical exercise that is not relevant to any issue before the Commission. [IAWC Ex. 4.0SR, p. 5.] The issue is whether the Illinois ratepayers would be subsidizing non-utility operations and, as discussed above, the Illinois DCF Analysis confirms that this is not the case.

Staff (Br., p. 31) also discusses Ms. Langfeldt's criticism of Mr. Bobba's analysis, arguing that "[a]cquisition multiples are not sufficient for determining whether the purchase price is reasonable because each merger or acquisition transaction is a function of unique factors that contribute to the acquirer's perception of value." As Mr. Bobba indicated, however, the five

financial statistics which he chose to evaluate the reasonableness of the purchase price were selected because they are publicly available and are routinely considered by investment bankers for that purpose. [Tr. 343.] Mr. Hartnett also addressed this issue, explaining that acquisition multiples are the standard method used by investment bankers for verifying the reasonableness of the purchase price in all industries, not just water utility acquisitions. [IAWC Ex. 4.0R, p. 7.]

The considerations mentioned by Ms. Langfeldt are the unique factors that an acquirer will consider in determining its offer price for the properties. There is a key distinction between determination of the specific value a willing buyer is prepared to pay to a willing seller versus the determination of how that purchase price compares to other transactions in the market for similar companies at that time. AWW determined the price it was willing to pay for Citizens' assets (based on the DCF analysis discussed by Mr. Hartnett). Mr. Bobba compares AWW's price and the resulting multiples for reasonableness compared to similar transactions in the market for water utilities at the time of the offer. Mr. Bobba's analysis is appropriate to evaluate the reasonableness of the negotiated price. [IAWC Ex. 4.0R, p. 6; Tr. 343.] The use of these multiples is readily apparent in Proxy Statements routinely filed with the SEC for acquisitions of public companies. In addition, research analysts in the securities industry also use this information to determine the reasonableness of a purchase price. [IAWC Ex. 4.0R, p. 7.]

Ms. Langfeldt is criticizing a standard practice used by Merrill Lynch, and every investment banking firm on Wall Street, to determine the reasonableness of a purchase price relative to comparable transactions. [*Id.*, p. 7.]

At page 32 of its Brief, Staff sets forth an extra-record discussion of certain proprietary schedules. Because this discussion is extra-record and it is not possible to determine what line, column or information on the schedules is being referred to, the discussion should be

disregarded. Moreover, even if Staff was correct in asserting that the price paid by AWW for assets in several states results in multiples which exceed the average for certain multiples (but not others), this information has no significance. No one has testified that the referenced data has any meaning. Furthermore, the data referenced by Staff pertains to the overall transaction in six states. Reasonableness of the purchase price in Illinois was confirmed by Mr. Bobba's analysis and the Illinois specific DCF analysis. [IAWC Exs. 6.0, p. 3 (Bobba); 4.0R, p. 3 (Hartnett).]

Staff (Br., pp. 34-35) next addresses assertions related to its position that, because the acquisition adjustment is a transaction cost, its recovery under the SSP constitutes "unjust subsidization" and its position that the SSP would have an adverse effect on rates. These assertions are addressed in the Company's Initial Brief (at pages 42-45 and 38-42, respectively) and in other Sections of this Reply Brief.

K. Adverse Rate Impact

Staff (Br., pp. 38-39) suggests that adoption of the SSP can have an adverse effect on rates. Staff (Br., pp. 38-39) says that this is "[f]or reasons set forth in this Brief, including the fact that the savings plan allows for the development of a revenue requirement which exceeds the cost of operating the utility systems in question..." Staff's argument (Br., p. 39) also refers to its position regarding calculation of the Acquisition Premium. Staff's position that the SSP allows for development of a revenue requirement which exceeds the cost of service was discussed above. Staff's argument regarding the amount of the Acquisition Premium also has been discussed, and we will not further address those points.

We do note, however, that the SSP can have no adverse impact on rates at any time. [IAWC Ex. 2.0, p. 10.] In rate orders issued for the combined Company, ratepayers would be

assigned at least ten percent (10%) of the Demonstrated Savings. Recovery of the Acquisition Revenue Requirement would be allowed under the SSP only to the extent of ninety percent (90%) of the Demonstrated Savings. When the shareholder's portion of the level of Demonstrated Savings exceeds the Acquisition Revenue Requirement, any additional Savings are shared between customers and shareholders on a 50%-50% basis. [IAWC Ex. 2.0, pp. 8-9.]

Mr. Stafford gave an example which illustrates the impact of the Acquisition and SSP: if a monthly water bill prior to the Acquisition is \$30 per customer and Acquisition-related savings are \$10 per customer per month, the customer will realize a \$1 reduction in his monthly bill (10% of savings). Consequently, the customer's bill, all else being equal, would be \$29. The other \$9 of savings will go to paying the Acquisition Revenue Requirement (unless the amount of Savings exceeds the Acquisition Revenue Requirement), but the customer's bill is still lower than it would have been without the Acquisition. [Tr. 600-01.]

IAWC's proposal would clearly provide customers with lower costs and better service, all at no risk to the customer. [IAWC Ex. 2.0R, pp. 7-8.] Furthermore, shareholders recover a portion of the Acquisition Revenue Requirement only to the extent that the level of Demonstrated Savings is adequate to cover the Acquisition Revenue Requirement. If there are no Acquisition Savings at all (an extremely unlikely scenario), rates would remain at the stand-alone level, with no possibility under the SSP that rates could increase as a result of the Acquisition. [*Id.*, p. 9.]

Staff (Br., p. 40) also claims that recovery of the Acquisition Adjustment "encourages inflation of the purchase price of utility assets at the expense of ratepayers due to the circular relationship between the utility's allowed earnings and the value of a utility to a potential purchaser. As the evidence shows, however, there is no such circular relationship. As

Mr. Ruckman explained, the purchase price for the Utility Assets and, therefore, the level of the Acquisition Adjustment, is fully supported by the level of the discounted value of the expected cash flow from the acquired Utility Assets, including the Acquisition Savings. This direct connection between discounted value of incremental cash flow resulting from the Acquisition and the Premium eliminates Staff's concern with regard to uncontrolled pricing. [IAWC Ex. 2.0R, p. 6.]

Also, as Mr. Hamilton explained and Staff fails to grasp, as long as recovery of a merger or asset acquisition premium results in no net cost increase to customers (as is the case here), there is a limit to what an acquirer would be willing to pay for utility assets. That limit would be that the sum of cash flows from existing operations and expected savings from an asset acquisition are a ceiling on the purchase price (and, therefore, the premium). The requirement that the transaction not result in any net cost to the customer provides the proper "checks and balances" to the amount of a merger or asset acquisition premium that a company can pay and expect to collect through rates. To the extent that a company pays a price in excess of the current value of DCF (including cash flow from savings), it should fully expect to absorb that excess premium without rate recovery. [IAWC Ex. 7.0R, pp. 11-12.] These principles are implicit in the SSP.

Staff (Br., p. 40) sets forth an example which is intended to show that, if an adjustment is made to reflect in rates the \$2,000 acquisition adjustment resulting from acquisition of a utility with a \$1,000 rate base for a purchase price of \$3,000, \$300 of "net revenue" will be available, in Staff's words, "through higher rates for service". This example shows that Staff completely misses the point. The example does not even mention "savings" resulting from the hypothetical acquisition. If there are no assumed savings, the example has nothing to do with this case and

should be ignored. On the other hand, if there are savings commensurate with the hypothetical \$2,000 acquisition premium, the savings will eliminate the need for Staff's assumed rate increase. If, in the example, the acquiring utility can bring about savings which more than exceed the increase in revenue requirement related to the \$2,000 premium, why should it not recover the cost of its investment in the assumed premium? We believe it should.

Staff (Br., p. 41) goes on to assert that recovery of the Acquisition Revenue Requirement promotes inflation of the purchase price of assets. As indicated above, however, under the SSP, the total Savings that are expected to result from the Acquisition act as a limiting factor to the purchase price because a company would expect to have to absorb the amount of any premium related to payment of a purchase price which exceeds the current value of DCF. As Mr. Hamilton explained, the purchase price in this transaction was negotiated on an arms-length basis between two independent parties and is, thus, the best indication of the fair market value of the Utility Assets. The maximum price that Illinois-American would have any incentive to offer for the CUCI water and wastewater Utility Assets would be equal to, or less than, the discounted value of cash flows (including Acquisition Savings) that it believed could be obtained if it owned the Utility Assets. Any premium in excess of the incremental amount of the discounted cash flows expected to be realized would be absorbed by shareholders. [IAWC Ex. 7.0R, pp. 12, 15.]

As Mr. Gloriod made clear, the primary focus should be on the Savings that can be produced by the Acquisition, not the price of the Acquisition. A proposal, such as the SSP, that limits the recovery of the investment to an amount consistent with realized Savings, eliminates Staff's perceived risk that allowing Acquisition Premium recovery could lead to ever higher asset purchase prices. [IAWC Ex. 1.0R, pp. 9-10.]

Staff (Br., pp. 41-42) references prior proceedings in which acquisitions or mergers were approved with no recovery of costs related to an acquisition premium. As Mr. Mülle explained, however, a regulatory commission should determine the extent to which acquisition-related costs should be allowed to be recovered on a case-by-case basis. As Mr. Mülle indicated:

Garfield and Lovejoy, in what has become a classic text in utility rate making over the years, Public Utility Economics, have devoted considerable time and space to the subject of utility acquisition adjustments. As suggested in their text, acquisition adjustment settlements or decisions by commissions should be made on a case by case basis, rather than by a general rule. Under the circumstances of this case, recognition of the Acquisition Revenue Requirement (through adoption of the SSP) is appropriate and necessary as a matter of proper regulatory approach and policy. [IAWC Ex. 8.0R, pp. 10-11.]

In its Initial Brief, the Company cited numerous orders of regulatory commissions in which recovery of the acquisition adjustments was allowed through savings sharing or other approaches. (*Eastern Enterprises and Essex County Gas Co.*, DTE 98-27, 188 PUR 4th 225, 1998 WL 802109 (Mass. DTE, Sept. 17, 1998) (acquisition adjustment recovered through savings sharing); (*United Water Idaho, Inc.*, Docket No. UWI-W-97-6, Order No. 27617, 187 PUR 4th 312) (Idaho PUC, July 6, 1998) (acquisition adjustment accorded rate base treatment). See the additional orders cited at pages 20-27 of the Company's Initial Brief. Furthermore, Staff (Br., p. 42) seems to agree that issues regarding acquisition adjustment recovery and savings sharing should be approached on a case-by-case basis.

In the present case, Joint Applicants have offered an Acquisition which can bring substantial savings and other benefits to customers. As IAWC Exhibit 3.6R demonstrates, customers have the opportunity to realize at least \$137,236,647 (or 68% of the total available net savings) if the Acquisition and SSP are approved. Furthermore, under the SSP, this opportunity is provided with no possibility that rates would, at any time, increase to fund the Acquisition. In this case, shareholders ask for the opportunity to recover the Acquisition Revenue Requirement

under the SSP from the shareholder portion of Demonstrated Savings with no risk to the ratepayer. [IAWC Ex. 1.0R, p. 11.] As has been discussed, recovery of the Acquisition Revenue Requirement is essential to prevent financial impairment of the Company. [*Id.*, p. 5.] Under the SSP, the shareholders also would receive a reasonable portion of the available net savings (32%) in recognition of the risk which shareholders bear under the 40-year period of the SSP. [IAWC Ex. 8.0R, pp. 4-5.] As Mr. Mülle explained, the forty-year term of the SSP is reasonable in light of the long-term nature of the assets acquired, their financing lives and other factors. [*Id.*, p. 14.] Mr. Mülle further indicated that, without the opportunity to realize a share of savings, there would be no incentive for shareholders to assume all risk associated with the Acquisition Revenue Requirement. [*Id.*, p. 5.] Based on the circumstances of this case, the Company submits that the Acquisition and SSP are both reasonable; and they both should be approved because this is the only way the Acquisition may be approved under Section 7-204.

L. Treatment of CIACs and Advances

Staff (Br., pp. 43-44) also argues that contributions-in-aid-of-construction ("CIAC") and advances which Illinois-American will not acquire from CUCI should be recorded on Illinois-American's books. As the record shows, however, CIACs are not being recorded on the Company's balance sheet because CUCI is selling assets. Mr. Hamilton explained the reasoning for this treatment, and confirmed its appropriateness. As Mr. Hamilton indicated, how CUCI financed its water and wastewater utility assets prior to the acquisition of those assets is irrelevant in the context of an asset purchase transaction. Illinois-American is buying the Utility Assets for cash and, therefore, is financing those assets with debt and equity, which financing requires a return. In effect, Illinois-American has replaced the CIAC and advances with shareholder funds and will incur the cost to finance that debt and equity. [IAWC Ex. 7.0R, p.

10.] Nevertheless, as Mr. Ruckman explained, IAWC will not propose to require its customers to pay a return on the assets previously contributed to CUCI. The Company will recognize CIACs for ratemaking purposes in its development of rate base. The level of CIACs on Citizens' balance sheet at closing will be recorded as a rate base deduction, and diminished over time by the accumulation of amortization of CIACs (Account 272). Accordingly, no adverse rate impact will result and the concerns that Staff raises are satisfied. [IAWC Ex. 2.0R, p. 13.]

Mr. Ruckman explained that the Company will treat advances in the same manner as CIACs in the calculation of rate base. [*Id.*, p. 13.]

II. IIRC'S REMAINING CONTENTIONS

Certain of IIRC's contentions were addressed above in connection with the discussion of issues raised by the Staff. The following sections will discuss those contentions which were not previously addressed.

A. The Premium is Too Large

IIRC notes (p. 5) that the size of the Acquisition Adjustment "drives the SSP." IIRC (Br., p. 6) also suggests that the size of the Acquisition Adjustment causes "timing impediments" to its recovery. While we might not express the point in quite the same way, IIRC is correct in noting that the SSP is carefully designed to provide shareholders with an opportunity to recover the Acquisition Revenue Requirement over a forty-year period.

As has been discussed, the SSP does this while creating no risk at all of increased customer rates. Under the SSP, shareholders have the opportunity to recover the Acquisition Revenue Requirement, and the ratepayers have the opportunity (with no cost or risk) to realize significant Savings. This is because the "sheer size" of the Acquisition Savings is commensurate with the amount of the Acquisition Premium.

As Mr. Gloriod discussed, IWC's witness, Mr. Gorman, cites no standard for judging the relative amount of Acquisition Costs and Savings. Mr. Gorman also fails to note that, under the SSP, nearly \$140 million in net Savings will be returned to the ratepayers (Exhibit 3.6R) [IWC Ex. 1.0, p. 11.] (The present value of which, as adjusted to include the terminal present value, exceeds \$90 million. IWC Ex. 9.0R, pp. 16-17.) Such Savings are made possible only through the Acquisition. The shareholders are willing to spread their recovery of the Acquisition price over a forty-year period and to take the risk of limiting such recovery to Demonstrated Savings. The size of the Acquisition Adjustment and length of time over which the SSP will extend should not be a basis for disapproval of the SSP, which clearly will benefit the ratepayers. [IWC Ex. 1.0R, p. 11.]

B. Relative Share of Savings

As already discussed, over the forty-year period of the SSP, customers are expected to receive nearly \$140 million of the net Savings (68% of the total). [IWC Ex. 3.6R.] Savings allocated to shareholders over forty years on a current dollar basis are approximately \$64 million (32% of the total). [IWC Ex. 3.6R.] As IWC notes in its Brief (p. 12), the present value of the customers' portion of Savings (excluding the terminal present value) is approximately \$16.1 million, which is approximately 20% of the present value of total net Savings. [IWC Ex. 3.5R.] In comparison, the present value of net Savings allocated to shareholders is a negative \$12 million. [Tr. 599.] As shown on IWC Exhibit 3.5R, the remainder of net Savings on a present value basis (approximately \$76 million) is used to pay the Acquisition Revenue Requirement.

Although shareholders bear all risk related to the SSP and receive a lesser percentage of net Savings either on a current dollar or present value basis than do customers, IWC complains

in its Brief (pp. 12-14) that ratepayers should receive more. IIWC's primary concern seems to be the fact that, under the SSP, a portion of the Savings is used to fund the Acquisition Revenue Requirement. [IAWC Ex. 3.5R.]

IIWC suggests in its Brief (p. 12) that the Acquisition Revenue Requirement "is paid by ratepayers." This, of course, is not quite the full story. Under the SSP, shareholders receive an allocation of a portion of the available Savings to cover the Acquisition Revenue Requirement only if the Company demonstrates that such Savings are reflected in the test year data. Thus, rates do not increase to fund the Acquisition Revenue Requirement.

The evidence confirms that the purchase price for the Utility Assets is the fair value of those assets and that there would be no Acquisition if the purchase price were not paid. [IAWC Exs. 1.0, p. 9; 4.0, pp. 3-4.] The evidence also confirms that the Acquisition will benefit customers as a result of: (i) improved facilities, operations and service; and (ii) increased efficiencies as measured by the Savings [IAWC Ex. 1.0, pp. 9-10.] Furthermore, this Commission has recognized in past proceedings that, "to the extent that costs are incurred to produce savings (as is true with respect to the Acquisition Revenue Requirement) and are shown to be both reasonable and directly related, netting [of such costs against acquisition savings] is appropriate. As a matter of logic, the only savings that can be realized are net Savings" *GTE/Bell Atlantic*, Docket 98-0866, Order at 42. See also *Ameritech/SBC*, Docket 98-0555, Order at 149-50. Thus, the use of a portion of Savings realized under the SSP to fund the Acquisition Revenue Requirement is not a reasonable basis to criticize the SSP. Furthermore, as discussed above, the SSP's allocation of current dollar, net savings between ratepayers (68%) and shareholders (32%) is reasonable in light of the nature of the SSP and the assumption by

shareholders of all related risk. [IAWC Ex. 8.0R, pp. 4-5.] There is no basis to suggest that shareholders should receive less.

C. The Telecom Cases

In its Brief (pp. 16-17) IIRC argues that the two telecommunications proceedings referenced above, *Ameritech/SBC* and *GTE/Bell Atlantic*, are distinguishable from the present case. IIRC (Br., p. 15) notes correctly that neither case involved an Acquisition Adjustment or Premium. IIRC is incorrect, however, in suggesting (Br., p. 16) that the concept of "net savings", as discussed in the Orders in the two proceedings, differs in a meaningful way from the concept of "net savings", as that term is used in the present case. As the passage from *GTE/Bell Atlantic* quoted by IIRC (Br., p. 16) indicates, the costs to be netted against savings are "those incurred to produce savings and shown to be reasonable and directly related..." *GTE/Bell Atlantic*, Docket 98-0866, Order at 42. This same wording describes the costs to be netted against savings in *Ameritech/SBC*, Docket 98-0555, Order at 149-50. Furthermore, the evidence in this proceeding amply demonstrates that the Acquisition Premium is reasonable in amount and incurred to bring about the Acquisition Savings. [IAWC Exs. 1.0, pp. 9-10; 1.0R, pp. 3-4; 4.0, p. 4; 6.0, p. 3.] As discussed above and in the Company's Initial Brief (pp. 42-45), the evidence in this proceeding also confirms that the Acquisition Premium is not a "transaction cost" of the type discussed in *Ameritech/SBC* and *GTE/Bell Atlantic*. The Acquisition Revenue Requirement, therefore, qualifies under the standard set forth in Dockets 98-0555 and 98-0866 to be netted against Acquisition Savings.

IIRC also points out other differences between the two telecommunications cases and the present case, and even goes so far as to claim incorrectly that *GTE/Bell Atlantic* involved an "alternative rate plan" of the type applicable to *Ameritech*, the utility in Docket 98-0555. Suffice

it to say that the telecommunication carrier involved in *GTE/Bell Atlantic* was subject to traditional rate regulation of the type applicable to Illinois-American, and not an alternative rate plan filed under the then-effective version of Section 9-244 of the Illinois Public Utilities Act. Although IIRC's witness did not read the Order all the way through (Tr. 688), he did acknowledge that the Order recognizes expressly that the telecommunications utility involved is subject to traditional "rate of return" regulation (Tr. 688; e.g., Docket 98-0866, Order at 38). IIRC's counsel should be aware of this fact, in light of the reference in IIRC's Brief (p. 16) to the filing by the utility of a "general rate case" three years after closing of the transaction.

IIRC (Br., p. 16) also points out that, in *GTE/Bell Atlantic*, the utility agreed to implement an immediate rate reduction. In *GTE/Bell Atlantic*, however, the Staff had expressed a concern that the utility was over-earning, and the Order states expressly that the immediate rate reduction was proposed to address that concern. *GTE/Bell Atlantic*, Order at 37. No such concern has been expressed by Staff or any other party in this case. As Mr. Kelleher explained, unlike the telecommunications industry, the water industry is facing rising costs. [IAWC, Ex. 5.0, p. 7.] The savings resulting from acquisitions and mergers, however, mitigate the levels of rate increases which would otherwise be needed to cover those costs. [*Id.*]

The Acquisition Revenue Requirement should be netted against Savings just as the "costs incurred to produce savings" in *Ameritech/SBC* and *GTE/Bell Atlantic* were netted against savings. There is no basis to believe that savings, such as those here, which mitigate rate increases, are somehow less worthy of recovery than savings which allow rate reductions, and there is no basis to deny recovery of the "cost incurred to produce those savings" (the Acquisition Revenue Requirement). As IIRC (Br., p. 5) recognizes, when costs are incurred to

achieve savings in an amount which exceeds the costs, such costs should be recoverable.

[Tr. 684-85 (Gorman).]

D. Application of SSP to Current IAWC Rate Area

In its Brief (p. 17), IIWC notes that, over the term of the SSP, customers outside the CUCI area can expect to realize Savings on a net present value basis of approximately \$3.6 million or 4.5% of total Savings as shown on IAWC Exhibit 3.5R.⁸ As proposed by the Company, the Acquisition Revenue Requirement would be recovered from rate areas in direct proportion to the level of Acquisition Savings experienced in those areas. [IAWC Ex. 3.0SR, p. 8.] Thus, if approximately 4.5% of Savings are experienced in the current IAWC areas, approximately 4.5% of the Acquisition Revenue Requirement would be assigned to those areas. [*Id.*] IIWC (Br., p. 17) proposes that customers in the current IAWC areas realize the Savings, but incur none of the costs incurred to produce those Savings.

In support of this proposal, IIWC (Br., p. 18) indicates that, if no rate case is filed for the current IAWC areas for a three-year period, IAWC would "recover" approximately \$486,000 in Savings. IIWC fails to point out, however, that, in the interval between rate cases, other changes also occur. Certain operating costs, for example, can be expected to increase. Also, the Company invests between rate cases in plant additions. There is no evidence at all to suggest that Savings realized over the next two to three years in the current IAWC areas would be greater than changes which increase revenue requirements during the same period. Indeed, over the first three years, 4.5% of just the "Total Premium Revenue Requirement" (column 3 of IAWC Exhibit 3.5R) is \$1,056,465, more than twice the level of Savings for the period calculated by

⁸ Contrary to the suggestion of IIWC (Br., p. 17), the remaining savings (approximately 95.5%) go, not to CUCI, but to customers in the CUCI area. [IAWC Ex. 2.0R, p. 17.]

IIWC. Accordingly, there is no basis to assume that shareholders are somehow unjustly enriched by the opportunity for a reasonable period of time between rate filings to realize Savings which offset a portion of the increased costs which shareholders incur during that same period.

As discussed above, during the term of the SSP, shareholders, who bear all risk related to the SSP, have the opportunity to realize only 32% of net Acquisition Savings. [IAWC Ex. 3.6R.] On a net present value basis, shareholders realize no positive return at all. [Tr. 599 (Stafford).] The return to shareholders would be further eroded, if customers in current IAWC service area were provided with all Savings experienced in those areas, at the shareholders' expense. For these reasons, IIWC's position should be rejected.

E. Proof of Demonstrated Savings

IIWC (Br., pp. 19-20) discusses as an "undue risk for ratepayers" a concern that "[d]emonstrated savings may or cannot be disproved." Because of this, IIWC (Br., p. 20) states that, "ratepayers run the real risk that some portion of the Acquisition Revenue Requirement will be recovered." IIWC's point, however, is unclear.

If Demonstrated Savings are shown to exist in test year data (i.e., "cannot be disproved"), it is correct that, under the SSP, a portion of the Savings would be allocated to shareholders to cover all or part of the Acquisition Revenue Requirement (depending on the amount of the Demonstrated Savings). Also, rates would be reduced, because the first ten percent of Demonstrated Savings would be assigned to customers. Thus, IIWC's statement (despite the use of bold type, apparently for emphasis) makes no sense.

IIWC (p. 22) suggests that "confusion" exists with regard to statements made by Mr. Gloriod and Mr. Stafford. There is, however, no "confusion" because the witnesses are addressing two different things. In stating that the Company will maintain the records needed to

perform a cost-of-service study for the area now served by CUCI (Tr. 500-01), Mr. Gloriod is referring to the commitment made in his Direct Testimony to do just that. [IAWC Ex. 1.0, p. 6.] The referenced records, however, are not for CUCI on a stand-alone basis and are not used as a "baseline" for the determination of Savings. The referenced question at Tr. 500-01 does not refer to CUCI's stand-alone cost of service (although a prior question does). Mr. Stafford, on the other hand, is referring to the savings event methodology for determination of Savings and accurately points out that there is no reason to perform a cost-of-service study for an entire stand-alone company to provide baseline data for a savings event. [Tr. 560.]

IIWC (Br., p. 22) next suggests, without benefit of citation, that IAWC "poses a trending methodology." While Mr. Stafford does describe a trending approach (IAWC 3.0R, pp. 7-8), it is only one of several approaches discussed and not necessarily appropriate for a particular savings event. As Mr. Stafford indicates, IAWC believes that the methodology for measuring Savings should be determined in the future when additional information about the nature and amount of Savings is available. [IAWC Ex. 3.0R, p. 8.] In support of the SSP, the evidence in this case establishes that reasonable and workable methodologies for measurement of Savings are available.

IIWC (Br., p. 23) maintains that the Commission can "never know" whether a particular element of Savings is or is not related to non-acquisition related factors, such as technological change. As Mr. Ruckman explained, however, none of the Savings identified by the Company are the result of technological changes. [IAWC Ex. 2.0R, p. 4.] Moreover, subsequent to the Reorganization, if technological changes occur which would duplicate savings already realized (by virtue of elimination of duplication as a result of the Acquisition), that portion of the Acquisition Savings would no longer qualify as Acquisition Savings or Demonstrated Savings as

those terms are used in the Savings Sharing Proposal and would be eliminated from the equation. Acquisition Savings will include only those savings which result, and continue to result, from the Acquisition. Savings which result from a technological change would not be included in "Acquisition Savings," nor "Demonstrated Savings", and thus would not be used as a basis to allocate the Acquisition Revenue Requirement under the SSP. The burden will rest with IAWC in future rate cases to demonstrate that the Savings under consideration initially result from, and continue to result from, the Acquisition. [IAWC Ex. 2.0R, p. 4.]

IIWC (Br., p. 24) notes that the methodology described by IAWC for the careful measurement of savings for savings events require "extensive utility and commission involvement." As has been discussed, however, IAWC also has described other less "involved" approaches, such as the trending approach which, as discussed above, IIWC also criticizes. If the SSP is approved, IAWC intends to propose in future rate proceedings one or more appropriate methods to measure Savings which will be consistent with the type and amount of Savings involved.

F. Limit the Savings

IIWC (Br., p. 25) asserts that, if the Acquisition produces Savings not now known, shareholders should be denied any share of those Savings. This proposal should be rejected. IIWC offers no basis for the position that a portion of such Savings should not be used to fund the Acquisition Revenue Requirement or provide a return to shareholders as well as customers. As Mr. Stafford pointed out, Section 7-204 does not require a quantification of all savings in this proceeding and the Commission has indicated in past proceedings that the quantification of savings should be made at the time that the calculation is to be used for rate purposes. [IAWC

Ex. 3.0SR, p. 7.] The Company should be permitted to identify and quantify all Acquisition Savings which exist at the time of each future rate case. [*Id.*]

G. Specific Savings Items

IIWC (Br., pp. 29-30) also takes issue with Mr. Stafford's calculation of specific items of Savings. This area was addressed in the Company's Initial Brief (pp. 55-56), and will not be further addressed.

III. CONCLUSION

For the reasons discussed above and in the Company's Initial Brief, the Acquisition and SSP should be approved. In the alternative, if the Commission concludes that the Acquisition should be approved, but that the SSP should not, it should approve use of the alternative ratemaking proposal.

Respectfully submitted,

ILLINOIS-AMERICAN WATER COMPANY

By: 

One of Its Attorneys

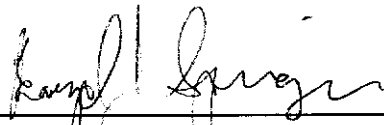
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Dated: March 9, 2001

CERTIFICATE OF SERVICE

Boyd J. Springer, an attorney, hereby certifies that he served copies of the "Reply Brief" and "Draft Order" of Illinois-American Water Company on the individuals shown on the attached Service List, via electronic mail and Federal Express next day delivery on Friday, March 9, 2001.



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